Public to Private Valuation Discounts

Most financial studies have concluded that there is a "private company discount" in valuing a firm relative to a similarly sized public company. The principal reason for the discount is the lack of marketability of the private company.

Koeplin Study (2000).

One such study titled "**The Private Company Discount**" was conducted to determine if transaction consideration paid for private companies was less than the transaction consideration paid in transactions involving matched publicly traded businesses. The study presented results from two analyses based on (1) domestic transactions, and (2) foreign transactions.

In order to conduct the analyses, the researchers identified matched pairs (one private company transaction and one public company transaction) based on four-digit industry SIC code analysis, proximity of transaction—within 12 months of one another—and size, based on sales revenue. The results are shown in Table 1, and indicates that an **18-20% reduction in EV/EBITDA multiples** are appropriate for public to private valuations.

TABLE 1 — KOEPLIN STUDY: PRIVATE COMPANY DISCOUNT ESTIMATE STUDY RESULTS FOR TRANSACTIONS OCCURRING BETWEEN 1994 AND 1998

	Private Company Transaction Multiples		Public Company Transaction Multiples		Private Company Discount Estimate [a]	
Domestic Company Transaction Data	Mean	Median	Mean	Median	Mean	Median
Enterprise Value/EBIT [b]	11.76	8.58	16.39	12.37	28.26	30.62
Enterprise Value/EBITDA [c]	8.08	6.98	10.15	8.53	20.39	18.14
Enterprise Value/Book Value	2.35	1.85	2.86	1.73	17.81	-7.00
Enterprise Value/Sales	1.35	1.13	1.32	1.14	-2.28	0.79
Foreign Company Transaction Data						
Enterprise Value/EBIT	16.26	11.37	28.97	12.09	43.87	5.96
Enterprise Value/EBITDA	11.96	7.10	25.91	9.28	53.85	23.49
Enterprise Value/Book Value	2.41	1.35	3.70	1.68	34.86	19.64
Enterprise Value/Sales	2.63	1.35	4.59	1.63	42.70	17.18

[a] Private Company Discount = 1- (private company transaction multiple ÷ public company transaction multiple).
[b] EBIT = Earnings Before Interest and Taxes.
[c] EBITDA = Earnings Before Interest, Taxes, Depreciation, and Amortization.

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Subsequent studies by Kooli in 2003 analyzed companies by industry classification (agriculture, mining, manufacturing, transportation, services, etc.) demonstrated that the manufacturing discount for public to private company transactions is about **22%.** (the discount indication based on transaction multiple price/cash flow).

Aside from the lack of liquidity of private firms, there are other reasons to suggest a discount from public valuations:

Valuation of Private vs. Public Firms

Why private companies tend to be valued lower than public firms

Q: Why are public companies in my industry valued so highly, oftentimes at price/earnings multiples of more than 20, when a recent valuation of my privately held business says I'm worth only four to six times my EBITDA?

A: There are a number of factors that are considered differently in the valuation of privately held vs. public companies—even those that are in the same industry—making a direct comparison for valuation purposes difficult. In some cases, it's like comparing apples to oranges. Following is a list of some of the issues that may result in differences between the valuations of public and private firms:

1. **Market liquidity.** As mentioned above, a lack of market liquidity is usually the biggest factor contributing to a discount in the value of companies. With public companies, you can, if you choose, switch your investment to the stock of a different public company on a daily (if not more frequent) basis. The stock of privately held firms, however, is more difficult to sell quickly, making the value drop accordingly.

2. **Profit measurement.** While private companies seek mostly to minimize taxes, public companies seek to maximize earnings for shareholder reporting purposes. Therefore, the profitability of a private firm may require restatement in order for it to be directly comparable to that of a public firm. In addition, public-company multiples are generally calculated from net income (after taxes), while private-company multiples are often based on pre-tax (and many times, pre-debt) income. This discrepancy can result in an inaccurate formula for the valuation of a private company.

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3. **Capitalization/capital structure.** Public companies within a specific industry generally maintain capital structures (debt/equity mixes) that are fairly similar. That means the relative price/earnings ratios (where earnings include the servicing of debt) are usually comparable. Private companies within the same industry, however, can vary widely in capital structure. The valuation of a privately held business is therefore frequently based on "enterprise value," or the pre-debt value of a business rather than the value of the stock of the business, like public companies. This is another reason why private-company multiples are generally based on pre-tax profits and may not be directly comparable to the price/earnings ratio of public firms.

4. **Risk profile.** Public companies usually provide an assurance of continuing operations above that of smaller, privately held firms. Downturns in the economy or a change in the environment (such as an increase in competition or regulatory changes) often have a greater impact on private firms than public firms in terms of performance and market positioning. That higher risk may result in a discount in value for private firms.

5. **Differences in operations.** It is often difficult to find a public company operating in the same niches as private firms. Public companies typically have operations spanning a broader range of products and services than do private companies. In addition, even if the products and services are the same, the revenue mix is often different.

6. **Operational control.** Although private companies are more likely to receive valuation discounts than public companies, there is at least one area where they may receive a value premium. While the sale of a private company usually results in the purchase of the controlling interest in the business, ownership of public-company stock generally consists of a minority-share ownership—which may be construed to be less valuable than a controlling-interest position. Given all these examples, you can see how the valuation of private companies is complex and often cannot be

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determined through the direct application of public company price/earnings ratios. Due to the complexities involved, one would be well advised to find a professional well-versed in private-company valuations to help you with this task.

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